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Splitting Specified Foreign Sourced Income between Tax Exempt and Taxable Portions: An Optimal Solution (Part 3 of 3)

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SPLITTING SPECIFIED FOREIGN-SOURCED INCOME BETWEEN TAX EXEMPT AND TAXABLE PORTIONS

An Optimal Solution (Part 3 of 3)

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This is the final piece of a three-part series. In Article 2, published in ***IS Chartered Accountant***, February 2015, we had concluded that if a specified foreign income[1] qualifies for tax exemption under the foreign-sourced income tax exemption (FSIE) regime, and also for the foreign tax credit under the pooling system (PS), generally, tax exemption under the FSIE regime is more tax beneficial unless:

1) Prior to the inclusion of the specified foreign income, there is already an excess of pooled Singapore tax payable (STP) over the pooled foreign tax paid (FTP) in respect of the other foreign income, and
2) There will be an excess of the FTP over the STP in respect of the specified foreign income if it is not tax exempted.

Under the PS, the excess referred to in (2) can be offset against the excess in (1) above. This would mean a higher amount of pooled foreign tax credit granted eventually. However, with the inclusion of the specified foreign income, the "overall tax payable before foreign tax credit" will also increase. Therefore, one needs to test the "beneficial tax exemption" condition under the FSIE regime by determining the extent of the increase in the "overall tax payable before foreign tax credit" versus the extent of the increase in the pooled foreign tax credit granted. If the former exceeds the latter, then tax exemption is more beneficial. If the latter exceeds the former, the overall tax payable can be further reduced by not claiming the tax exemption under the FSIE regime.

In Article 2, the amount of foreign dividend income was treated as either fully tax exempt or fully taxable. In this article, we consider the various possible scenarios between these two extremes by determining whether the overall taxable position can be further improved if we were to treat only a portion of the foreign dividend income as being tax exempt and the remaining portion as being taxable.

ILLUSTRATION

Company A, a Singapore tax resident company, derives a local trade income of $3 million and receives in Singapore the following elected gross incomes[2] under the PS:

- Foreign interest income of $10,000 (FTP @ 8%);
- Foreign royalty income of $2 million (FTP @ 5%);
- It also derives and receives in Singapore a gross foreign dividend income of $5 million which qualifies for tax exemption under the FSIE regime and also for the foreign tax credit under the PS. The foreign dividend income suffered a foreign tax rate of 30%.

Table 1 shows the tax computation under two scenarios where the entire amount of the foreign dividend income is:
Scenario 1: Tax exempt under the FSIE regime;
Scenario 2: Taxable.
Foreign tax credit is claimed in respect of the interest income and royalty income under the PS.

[1] Specified foreign income refers to foreign dividend income, foreign branch profit and foreign service income.

[2] Elected income means any item of foreign income for which a resident person qualifies to claim the foreign tax credit under the PS.

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Table 1 Tax computation for Company A receiving foreign income

Amount of FDI subject to tax		Tax exempt	$5 million
		$	$
Local trade income		3,000,000	3,000,000
Foreign income:			
Interest income (FTP @ 8%, that is, $800)		10,000	10,000
Royalty income (FTP @ 5%, that is, $100,000)		2,000,000	2,000,000
FDI ($5 million exempt under the FSIE with foreign tax rate of 30%)		0	5,000,000
Normal chargeable income before Partial tax exemption	X	5,010,000	10,010,000
Less: Partial tax exemption		152,500	152,500
Normal chargeable income after Partial tax exemption		4,857,500	9,857,500
Tax payable before FTC (@ 17%)	Y	825,775	1,675,775
Less: FTC - lower of pooled FTP ($100,800, that is, $800 + $100,000) and pooled STP ($331,299[3])		100,800	-
Less: FTC - lower of pooled FTP ($1,600,800, that is, $800 + $100,000 + $1,500,000) and pooled STP ($1,173,545[4])			1,173,545
Net tax payable after FTC		724,975	502,230
			(724,975)
Tax savings			222,745
Excess of STP over FTP		230,499	
Excess of FTP over STP disregarded		NA	427,255
# Singapore effective tax rate (SETR)	Y/X	16.48253%	16.74101%

FI: Foreign income
FTC: Foreign tax credit

ANALYSIS OF TABLE 1

Electing for tax exemption under the FSIE regime for the foreign dividend income may not be beneficial for Company A as Table 1 indicates that:

a) There is an excess of pooled STP over the pooled FTP of $230,499[5] prior to the inclusion of the foreign dividend income, and
b) The FTP, at 30%, is greater than the STP[6] on the foreign dividend income if the foreign dividend income were to be subject to tax.

Under the PS, the excess of the FTP over the STP on the foreign dividend income in (b) could be used to offset against the excess[7] of the pooled STP over the pooled FTP in (a), but its utilisation is restricted to the amount of the excess in (a). Nevertheless, it would effectively mean a higher amount of overall pooled foreign tax credit granted. However, with the inclusion of the foreign dividend income, the overall tax payable before the foreign tax credit also increases.

The extent of the increase in both the "overall tax payable before the foreign tax credit" and the amount of the "overall pooled foreign tax credit granted" will depend on the amount of the foreign dividend income that is treated as being taxable. In this case, it is not beneficial for Company A to claim tax exemption on the entire amount of the foreign dividend income under the FSIE regime as opposed to having the entire amount of the foreign dividend income subject to tax and then claiming the foreign tax credit under the PS. The latter tax treatment can bring down its tax by $222,745.

Although tax exemption on the foreign dividend income under the FSIE regime is not beneficial to Company A, the question is whether having the entire amount of the foreign dividend income being taxable is optimal for Company A.

Table 2 shows the tax savings arising from the difference between the taxes payable for each of the Combinations B to K (reflecting different amounts of tax exempt and taxable portions of the foreign dividend income), and Combination A (when the entire amount of the foreign dividend income is tax exempt).

ANALYSIS OF TABLE 2

By first treating the $1 million portion of the foreign dividend income as being taxable under the PS and the remaining $4 million as being tax exempt (Combination B), the amount of tax savings is approximately $130,000. As this taxable portion increases (from Combinations B to D), the corresponding tax savings also increase. As the taxable portion increases beyond that in Combination D, tax savings start to taper off to $222,745, which is the point when the entire amount of the foreign dividend income is treated as being taxable (Combination K).

Hence, it is not optimal for Company A to have the entire amount of the foreign dividend income subject to tax (Combination K). This is because there is still an excess of the FTP over the STP (that is, $427,255) in respect of the foreign dividend income that is disregarded (Table 2, column v). The implication is that an excessive amount of foreign dividend income has been

3 ($10,000 + $2,000,000) x SETR of 16.48253%
4 ($10,000 + $2,000,000 + 5,000,000) x SETR 16.74101%
5 $331,299 (pooled STP) less $100,800 (pooled FTP)
6 Maximum rate is at the prevailing corporate tax rate of 17%
7 This excess is expected to increase as the Singapore effective tax rate (used to compute the pooled STP) increases with the inclusion of the foreign dividend income.

Table 2 Tax savings from tax treatment in Combinations B to K over Combination A

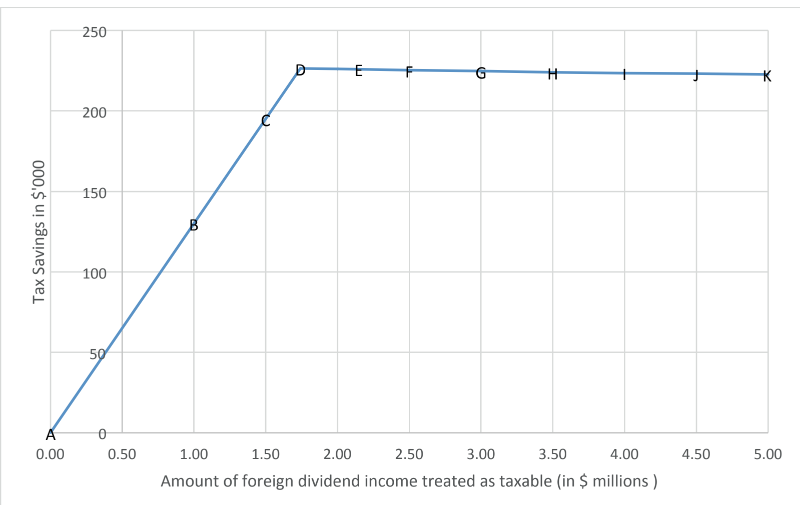
(i)	(ii)	(iii)	(iv)	(v)	(vi)
Combination #	Amount of FDI exempt under the FSIE ($)	Amount of FDI subject to tax ($)	Tax savings ($)	Excess of pooled FTP over pooled STP disregarded ($)	Excess of pooled STP over pooled FTP ($)
A	5,000,000	0	NA	NA	NA
B	4,000,000	1,000,000	130,000	0	97,916
C	3,500,000	1,500,000	195,000	0	31,922
D	3,257,743	1,742,257	226,493	0	0
E	3,000,000	2,000,000	226,070	33,930	0
F	2,500,000	2,500,000	225,331	99,669	0
G	2,000,000	3,000,000	224,685	165,315	0
H	1,500,000	3,500,000	224,114	230,886	0
I	1,000,000	4,000,000	223,607	296,393	0
J	500,000	4,500,000	223,153	361,847	0
K	0	5,000,000	222,745	427,255	0

subject to Singapore tax for which the foreign tax credit is not granted for the FTP paid on such an amount.

An optimal amount of foreign dividend income that should be subject to Singapore tax is the combination in Table 2 that reduces both "the excess of the pooled FTP over the pooled STP" (column v) and "the excess of the pooled STP over the pooled FTP" (column vi) to zero, which is Combination D.

Figure 1 shows that Combination D has the maximum tax savings when the $1,742,257 portion of the foreign dividend income is treated as being taxable, and the remaining $3,257,743 portion is treated as being tax exempt under the FSIE regime.

Figure 1 Tax savings arising from differences between taxes payable for Combinations B to J, and Combination A



CONCLUSION

Tax exemption under the FSIE regime is granted where it is beneficial to the resident person. Where a specified foreign income qualifies for tax exemption under the FSIE regime and also for the foreign tax credit under the PS, tax exemption on the entire amount of specified foreign income under the FSIE regime may not always be necessarily beneficial. In most situations, it may be more tax beneficial to treat a certain portion of the specified foreign-sourced income as tax exempt under the FSIE regime, and the remaining portion as taxable under PS. The optimal combination will be the one where both "the excess of the pooled FTP over the pooled STP" and "the excess of the pooled STP over the pooled FTP" are reduced to zero. ISCA

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